

**Issue:** Business/Non-Business (General)  
1005 Penalty (Reasonable Cause Issue)

THE DEPARTMENT OF REVENUE )  
OF THE STATE OF ILLINOIS )  
 )  
 v. ) DOCKET: XXXXX  
 )  
XXXXX ) Hollis D. Worm  
 Taxpayers ) Administrative Law Judge

A hearing was held on XXXXX. Upon consideration of all the evidence,

as well as the points and authorities relied upon by the parties, it is recommended that the issues be resolved in favor of the Department and against the Taxpayer.

FINDINGS OF FACT:

1. The Taxpayer was incorporated in 1916 and is in the business of manufacturing advanced technology products for automotive, electronics, defense and capital goods markets worldwide. (DOR Ex. 4).

2. A Notice of Deficiency in the amount of \$236,167 covering the taxable years ended December 31, 1989 and December 31, 1990 was issued to the Taxpayer on May 5, 1993 (DOR Ex. 8), to which the Taxpayer responded with a timely Protest and Hearing Request on June 15, 1993. (DOR Ex. 9).

3. On June 24, 1994 a Hearing was held in this matter pursuant to formal notice. At the hearing Mr. Relphorde introduced DOR Exs. 1 through 9 to establish the Department's prima facie case.

4. During the audit period, the Taxpayer claimed nonbusiness income in the amounts of \$42,755,614 and \$16,036,328, respectively, for the 1989 and 1990 taxable years. These amounts were derived from interest income, rental income, royalty income, and capital gains from the sale of intangible personal property. The auditor reclassified all of these amounts as business income subject to apportionment in Illinois. (DOR Ex. 4).

5. XXXXX received interest from municipal bonds, certificates of deposit, and imputed interest from the sale of XXXXX stock to the automotive industry. (DOR Ex. 4).

6. The rental income was derived from the renting of office space to third parties in its office building. The Taxpayer also had a subsidiary that was involved in the leasing business. (DOR Ex. 4).

7. The royalty income was derived from the licensing of some of the Taxpayer's patents to unrelated companies. (DOR Ex. 4).

8. The capital gains arose from the sale of stock in some of the

Taxpayer's subsidiaries. (DOR Ex. 4).

9. The Taxpayer presented no clear or convincing evidence that the above items were not business income.

10. XXXXX XXXXX was formed by the Taxpayer in order to receive excess funds from XXXXX and its subsidiaries. XXXXX XXXXX did not invest the funds but rather received interest and dividends from an investment company to which it had turned over the excess funds from XXXXX and its subsidiaries. (DOR Ex. 4).

11. A Notice of Decision had been issued to XXXXX regarding the 1984 through 1988 taxable years by the Illinois Department of Revenue. One of the issues in that Notice of Decision was the reclassification from nonbusiness income of interest and rental income and capital gains as business income. The Director upheld the Notice of Deficiency in its entirety and no appeal has been filed by the Taxpayer.

CONCLUSIONS OF LAW: S.H.A. 35 ILCS 5/1501(a)(1) defines the term business income to mean:

...income arising from transactions and activities in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations....

Illinois Administrative Code, Ch. I, {100.3050(a) further provide that a person's income is business income unless clearly classifiable as nonbusiness income. Nonbusiness income means all income other than business income.

A taxpayer has the burden of proving that a particular item of income is nonbusiness income, National Realty & Investment Company v. The Department of Revenue, 144 Ill. App. 3d 541, 494 N.E. 2d 924 (2d Dist. 1986). To sustain that burden a taxpayer must prove the nonbusiness character of the income by clear and convincing evidence, Howard Johnson Company v. Department of Revenue of the State of Illinois, Ill. Cir. Ct., 81 L 4368 (Cook Cty., 1982). The Taxpayer has not met its burden in this

case. Therefore, the interest, rental income, royalty income and capital gains from the sale of intangible personal property should be treated as business income subject to apportionment in Illinois.

35 ILCS 5/1501(a)(8) defines the term financial organization to mean:

... any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company....

The Taxpayer presented no evidence to substantiate that it met any of the definitions of a financial organization. Therefore, the Taxpayer should be barred from treating XXXXX XXXXX as a one-factor financial organization and the auditor's treatment of XXXXX XXXXX as a three-factor company should be upheld.

35 ILCS 5/1005 provides a penalty for any underpayment of tax unless it is shown that such failure is due to reasonable cause.

The existence of reasonable cause justifying abatement of a penalty is a factual determination that can only be decided on a case by case basis, *Rorabaugh v. United States*, 611 F. 2d 211 (7th Cir., 1979) and has generally been interpreted to mean the exercise of ordinary business care and prudence, *Dumont Ventilation Company v. Department of Revenue*, 99 Ill. App. 3d 263, 425 N.E. 2d 606, 54 Ill. Dec. 741 (3rd Dist., 1981). The burden of proof is upon the Taxpayer to show by a preponderance of the evidence that it acted in good faith and exercised ordinary business care and prudence in providing for the timely payment of its tax liability.

The Taxpayer presented no evidence to support a finding that it made a good faith effort to determine its proper income tax liability. In fact, the Taxpayer had previously been issued a Notice of Decision by the Department upholding the Department's position on the business income issue. The Taxpayer therefore failed to prove that it exercised ordinary business care and prudence in providing for the timely payment of its tax

liability and that reasonable cause was the basis for its failure to pay its entire tax liability when due.

RECOMMENDATION: In accordance with the foregoing it is being recommended that the Director of Revenue issue his Notice of Decision upholding the Notice of Deficiency issued for the 1989 and 1990 taxable years in its entirety.

Hollis D. Worm  
Administrative Law Judge

Date: December 29, 1994